

BEFORE THE POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

Periodic Reporting
(NPPC et al. Proposal One)

Docket No. RM2023-3

**STATEMENT OF JOHN C. PANZAR ON BEHALF OF
MAILER COMMENTS ON THE APPROPRIATE ANALYTICAL
PRINCIPLE FOR RETIREE HEALTH BENEFIT NORMAL COSTS**
(February 8, 2023)

I. INTRODUCTION

My name is John C. Panzar. I am the Louis W. Menk Professor of Economics, Emeritus, at Northwestern University. My professional work has included analysis of economic pricing and costing principles for the United States Postal Service and other multiproduct firms. Since 1984, I have sponsored testimony before the Postal Regulatory Commission (“PRC” or “the Commission”) and its predecessor, the Postal Rate Commission, for several parties, including the Commission itself. In 2014, the Commission contracted with me to prepare a report on the proper role of costs in postal regulation.¹

The purpose of this statement is to support the Mailers’ Comments on the Appropriate Analytical Principle for Retiree Health Benefit Normal Costs. The Mailers

¹ Panzar, John (2014); “The Role of Costs for Postal Regulation,” Postal Regulatory Commission. The report continues to be available at:
<https://www.prc.gov/sites/default/files/reports/J%20Panzar%20Final%20093014.pdf>

request that the Commission adopt changes to the current accepted analytical principles necessary to ensure that a portion of the retiree health benefits normal costs (“RHB normal costs”) are properly attributed to those products that caused those costs at the time the benefits are earned, regardless of whether an actual payment is due for the costs and, thus, whether these recognized “economic costs” are also recognized as “accounting costs.”

Specifically, the Mailers urge the Commission to amend the current analytical principle that purports to cap attributable costs at an amount less than the recognized accounting costs – “total accounting costs serve as a ceiling that attributed costs cannot exceed.”² The Mailers refer to this analytical principle as the “accounting cost cap.”³ Whatever the intuitive merits of this analytical principle in other circumstances, it cannot be maintained as applied to RHB Normal Costs under the Commission’s interpretation of the accounting effects of the Postal Service Reform Act of 2022, because doing so would impermissibly result in the failure to attribute economic costs via reliably identified causal relationships.

I support the Mailers position because it is compelled by the statutory causation-based standards for cost attribution and because it is fundamental to a costing system based on sound economics. Most importantly, this statement explains, once again, why ratemaking policies that promote economic efficiency, such as Efficient Component

² See Docket No. RM2023-3, Order Denying Request for Reconsideration and Notice of Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (NPPC et al. Proposal One) (Order No. 6430)(January 25, 2023), at 19

³ See Docket No. RM2023-3, Comments on the Appropriate Analytical Principle for Retiree Health Benefit Normal Costs (Feb. 8, 2023), at 2.

Pricing (“ECP”), *must* be based upon an attributed cost methodology that reflects underlying economic costs based on reliably identified causal relationships.

II. DISCUSSION

A. Causality Is The Basis For Economic Costs. RHB Normal Costs Are *Caused By Work Done And Benefits Earned Today*.

Both the Commission and the Mailers agree that the economic costs associated with future retiree health benefits are a result of work performed in the current period.⁴ The Commission states:

Economic costs include costs for benefits as benefits are earned regardless of whether an actual payment is due for the costs (and thus regardless of whether the economic costs are also accounting costs).⁵

This conclusion hardly differs from repeated statements by the Mailers to the effect that, “the Postal Service will incur (and accrue) retiree health benefit costs, as described above, daily as postal employees do their work, just as in past years.”⁶ That is, RHB normal costs for future benefits are *caused* by current volumes of mail to the same extent that current wages are *caused* by current volumes of mail. Equivalently, these costs would be *avoided*

⁴ Interestingly, the Postal Service has taken the same position in the past: “During FY 2007 employees earned pension and retiree health benefits that will be paid in the future during their retirement years. The amount of benefits earned or alternatively the additional future obligations taken on by the Postal Service is part of the compensation paid employees, just like salaries and benefits provided while employed (such as health benefits).” SUPPLEMENT TO USPS-FY07-2: Treatment of Annuitant Health and CSRS Benefits Costs

⁵ Order No. 6430 at 18.

⁶ Docket No. RM2023-3, Motion for Reconsideration or, in the Alternative, Petition to Initiate a Proceeding Regarding the Appropriate Analytical Principle for Retiree Health Benefit Normal Costs (Dec. 19, 2022), at 12.

if those current volumes were to disappear.⁷ The Commission expressly recognizes this fact in Order No. 6430:

This is not to say that the economic costs of retiree health benefits do not exist in FY 2022. As discussed above, economic costs include costs for benefits as benefits are earned, and retiree health benefit normal costs were earned by employees in FY 2022. However, as also discussed above, it is the Postal Service's accounting systems that record the costs that the Postal Service accrues each fiscal year, and because attributable costs are a subset of total postal costs, they cannot exceed the corresponding total accounting costs as recorded by the Postal Service's accounting systems.⁸

Therefore, there is no dispute that but for the accounting cost cap, the RHB normal costs earned in fiscal year 2022 are economic costs that would otherwise be attributed to specific products through reliably identified causal relationships.

⁷ See Panzar (2014) for a discussion of the equivalence between cost causality and cost avoidance.

⁸ Order No. 6430 at 23-24.

B. The Statutory Causation-Based Costing Requirements Require Attribution of Economic Costs.

The language and history of the current statutory causation-based costing requirements dispose of any perceived tension between accounting costs and economic costs. Prior to the Postal Reorganization Act of 1970, the Postal Service relied on a costing system that allocated costs through arbitrary accounting conventions with no causal basis. Following the lead of the Kappel Commission, Congress expressly endorsed in the 1970 Act a ratemaking system that set minimum price floors based on attributable costs. The Postal Accountability and Enhancement Act of 2006 carried this effort forward by codifying the causation-based costing standards developed by the Commission and reviewing courts under the 1970 Act.

Commission decisions under the PAEA have made clear that attribution of costs to an individual mail class or product without a reliable showing that the costs are caused by the particular mail class or product is unlawful. The converse is equally true, statutory causation-requirements require that costs caused by a particular mail class or product must be attributed. That is, only costs actually caused by a particular mail class or product can be attributed to that mail class or product and price floors must be based upon attributable costs.

The statutory causation-based costing requirements are mandatory. Section 3622(c)(2) states, in part, a “requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships” 39 U.S.C. § 3622(c)(2). Section 3633(a)(2) imposes the same requirement on competitive products. 39 U.S.C. § 3633(a)(2). The statutory workshare limitations likewise require, subject to exceptions not relevant here, that the Commission “ensure that such discounts do not exceed the costs that the Postal Service avoids as a result of workshare activity[.]” 39 U.S.C. § 3622(e)(2). These statutory provisions unambiguously require that economic costs must be attributed to specific mail classes or products. The Commission cannot adopt a rule or analytical principle that violates these mandatory statutory requirements.

Order No. 6430 concedes there are real economic costs associated with RHB normal costs in FY2022, but these economic costs are not being attributed by operation of the accounting cost cap. To the extent the Commission’s interpretation of the accounting treatment of the PSRA creates this irreconcilable conflict between an accepted analytical principle and the mandatory statutory causation requirements, the analytical principle must be changed.

C. Economic Costs, Not Accounting Expenses, Form The Basis For Efficient Rate Making.

The Commission has long endorsed Efficient Component Pricing (“ECP”) – i.e., the principle that worksharing discounts equal the amount of Postal Service costs avoided – as a fundamental principle of efficient ratemaking. “The Commission has determined

that to measure pricing efficiency, it will evaluate whether prices were set using ECP and allocative efficiency.”⁹ The Commission fully recognized the reason that ECP promotes efficiency:

When a discount equals its avoided cost, the Postal Service neither gives too great a discount (i.e., the discount exceeds what it costs the Postal Service to perform the work) nor too little a discount (i.e., the discount is less than what it costs the Postal Service to perform the work, and although a mailer could perform the work at a lower cost than the Postal Service, it may not if the cost to the mailer for performing the work exceeds the amount of the discount). This type of pricing efficiency also promotes fair competition, because it allows mailers to determine if they can prepare the mail at a lower cost than paying the Postal Service to do the work.¹⁰

As has been pointed out many times before,¹¹ it is important to recognize that, in order for ECP to perform “its magic,” the costs referred to above must be economic – i.e., avoidable – costs. That is, the attributable costs of the Postal Service must include *all* of the Postal Service costs that would disappear if the mailer performed the work instead. For workers performing a particular task *today*, the discounted present value of the expected retirement healthcare benefits they earned *today* represents part of the economic costs of

⁹ Docket RM2017-3, Order on the Findings and Determination of the 39 U.S.C. § 3622 Review (Dec. 1, 2017), Order No. 4257, at 135.

¹⁰ Order No. 4257, at 130-131.

¹¹ See e.g., Docket No. R2006-1, Revised Direct Testimony of John C. Panzar on Behalf of Pitney Bowes Inc. (PB-T-1)(Oct. 31, 2006), at 23-24: “It is important to point out that it is the incumbent’s avoided costs that are relevant for the calculation of the cost-based discount used to determine efficient access prices. This follows from the fact that such prices are designed to implement an efficient “make or buy decision” for society. The consolidator can be counted upon to do his part by taking recognition of his costs where required. But the costs actually saved by the incumbent, and not some alternative cost standard, must be the ones used to calculate unbundled access charges if decentralized entry decisions are to result in socially cost efficient outcomes.” (emphasis added).

providing a service *today*, just like their wages. Such costs must be included when calculating *today's* ECP discount, because the mailer will compare that discount to its own economic costs when deciding, *today*, whether or not to do the work itself. The timing of the expenses incurred by the Postal Service (or the mailer) in obtaining today's labor services plays no role in the efficiency calculation.

A simple example will help illustrate this point. Suppose that the Postal Service's labor contract stipulates that the labor required to perform a certain potentially workshared task is to be paid \$80 in wages this period and a future retirement benefit with an expected discounted present value of \$20. Initially, the Postal Service pays, in the current period, for an insurance policy to cover this future liability at the actuarially fair price of \$20. As a result, the economic costs and the current expenses incurred by the Postal Service for this labor task are both \$100. Under ECP, \$100 would also be the worksharing discount for a mailer who performed this task itself. In this case, a mailer whose costs of performing the task were only \$90 would choose to perform the task itself, for a social economic cost savings of \$10.

Now suppose that the Postal Service no longer purchased an insurance policy in the current period to cover future worker retirement liabilities, instead assuming the liability to cover these costs in the future, as they were incurred. Clearly, the *economic costs* of the Postal Service for performing the task in the current period would not change. However, its labor bill in the current period for the task in question would be reduced by \$20, to \$80. If this current bill were erroneously used to determine a worksharing discount of \$80, our

hypothetical mailer with task costs of \$90 would choose not to perform the task and the \$10 social economic cost savings would not occur.

The inefficiencies and lost social cost savings illustrated in the above example are not merely hypothetical. In their comments on the 2022 ACR,¹² the National Postal Policy Council provide detailed examples of how the failure to attribute RHB normal costs distorts the proper evaluation of worksharing discounts. On the one hand, products with “measured” avoided cost passthroughs of greater than the 100% maximum would actually have less than a 100% passthrough had RHB normal costs been properly attributed. On the other hand, products with “measured” avoided cost passthroughs above the 85% minimum would have actually been below that threshold had RHB normal costs been properly attributed. The discounts for the first group of products would appear to be in noncompliance when, based upon economic costs, they would actually be in compliance. Conversely, the discounts for the second group of products would appear to be in compliance when they would actually be noncomplying. The NPPC examples make clear that the failure to properly attribute *all* relevant economic costs can have immediate adverse effects on ratemaking.¹³

¹² See Docket No. ACR2022, Comments of the National Postal Policy Council (Jan. 31, 2023), at 7-8, Tables 1 – 3.

¹³ The failure to attribute RHB normal costs will also distort the cross-subsidy tests for competitive products. However, there do not seem to be cases where a 6 to 7 percent cost understatement of incremental costs would, by itself, result in a product appearing to pass a cross-subsidy test when it actually failed.

III. CONCLUSION

In Order 6430, the Commission ruled that in order to attribute RHB normal costs as they are incurred would require a change to the analytical principles applied to the FY 2022 retiree health benefit normal costs. Fortunately, 39 C.F.R. §3050.11 allows the Commission to implement such a change, “[t]o improve the quality, accuracy, or completeness of the data or analysis of data contained in the Postal Service’s” regulatory reporting to the Commission.

For the reasons stated above, a change to ensure that pricing efficiencies are achieved by basing rates on a cost attribution methodology that reflects true economic costs is clearly an improvement in the “quality, accuracy, or completeness” of the costing methodology.